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No. _____

In The

Supreme Court of the United States

October Term, 1981

CENCO INCORPORATED,
Petitioner,

vs.

SEIDMAN & SEIDMAN,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Dated: July 29, 1982

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QUESTIONS PRESENTED

The decision by the Seventh Circuit presents a basic question of the responsibility of auditors within the federal scheme of investor protection. The Court of Appeals held that public accountants who become suspicious of fraud in a corporate client's financial statements, but who conceal their suspicions by issuing unqualified audit opinions to shareholders and directors, are nonetheless excused from responsibility to their client if some senior client managers were involved in the fraud.

The Seventh Circuit excused the auditors because "[f]rom the standpoint of deterrence" the onus of loss should fall upon investors who (knowing nothing of the fraud) elected the corporate directors who (also knowing nothing of the fraud) appointed the dishonest managers. Correspondingly, the Seventh Circuit removed the onus of loss from the auditors who (although suspecting the fraud) "perhaps to protect [their] very high fees . . . concealed their suspicions and kept giving [the client] a clean bill of health in their audit reports." (App. A3).

Federal law mandated the auditor-client contractual relationship with which this case is concerned. The federal securities regulations require that independent accountants provide annual audit reports informing public-company shareholders about the performance and stewardship of management. Under the federal scheme, auditors must help to protect shareholders from misinformation in selecting corporate managers. Under the Seventh Circuit's decision, however, auditors who breach that duty are excused from responsibility when the managers prove, in fact, to be dishonest.

The Seventh Circuit's decision presents two questions of law for review. Each question has exceptional importance to the role of auditors of public companies and to the operation of the national securities markets:

1. Should public accountants who contract to audit and report on a publicly-held corporation's financial

statements, as required by federal law for the protection of shareholders, be excused from liability to their client for knowingly concealing their suspicions of fraud solely because some senior client managers were involved in that fraud?

2. Should federal common law provide a uniform national rule determining the rights of publicly-held corporations to enforce audit and reporting obligations which their public accountants contracted to fulfill under requirements and specifications of the federal securities laws?

The Seventh Circuit's decision on the first question conflicts with the federal securities laws as implemented by regulations of the Securities and Exchange Commission and as interpreted by this Court. The court's decision on both questions conflicts with principles of law articulated by this Court and by other Courts of Appeals.

PARTIES TO THE PROCEEDINGS

Petitioner, Cenco Incorporated, was appellant and cross-appellee below. Cenco was a publicly-traded company until July 22, 1982, when its shareholders approved its merger into Manor Care, Inc. Cenco was a partly-owned subsidiary of Manor Care from October, 1981 until July 22, 1982. Partly-owned subsidiaries of Manor Care are Quality Inns International, Inc. and Prometur, S.A. de C.V. (Mexico).

Before October, 1981, Curtiss-Wright Corporation owned approximately 16% of Cenco's common stock. From October, 1975 to October, 1981, Curtiss-Wright treated Cenco as a "controlled corporation" for purposes of its federal reporting requirements.

Respondent, Seidman & Seidman, a partnership, was appellee and cross-appellant below.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner, Cenco Incorporated, respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered on March 26, 1982.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at Fed. Sec. L. Rep. (CCH) ¶98,615. The slip opinion is reproduced as Appendix A. The unreported order of the District Court denying Cenco's motion for judgment notwithstanding the verdict or, alternatively, for a new trial appears as App. B. The unreported judgment of the District Court on the jury's verdict appears as App. C. The District Court's instructions to the jury appear as App. D.

JURISDICTION

The judgment of the Court of Appeals (App. E) was entered on March 26, 1982. A timely petition for a rehearing

en banc was denied on April 30, 1982 (App. F). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Cenco's claims against Seidman in the District Court rested on federal question jurisdiction, 28 U.S.C. § 1331, Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, and the principles of pendent and ancillary jurisdiction.

STATUTES AND REGULATIONS INVOLVED

Appendix G reproduces the relevant portions of the statutes and regulations involved. These include parts of Sections 12 and 13 of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78*l* & m) and SEC Rules 2-02(b)-(d), 3-01(a), 3-02(a), 4-01(a)(1), and 14a-3(b) (17 C.F.R. §§ 210.2-02(b)-(d), 210.3-01(a), 210.3-02(a), 210.4-01(a)(1), and 240.14a-3(b)(1)).

STATEMENT OF THE CASE

Respondent, Seidman & Seidman, was petitioner Cenco's sole outside auditor during a five-year period when a twenty-million dollar inventory fraud took root and flourished in the company. Seidman discovered evidence of the fraud during its audits. By Seidman's admission, it had suspicions of fraud that it did not disclose to the directors and shareholders of Cenco. The District Court instructed the jury that Seidman could not be found liable to Cenco on any grounds if Cenco officers had participated in the fraud. Because the parties stipulated to such participation, the District Court's instructions effectively directed a verdict in Seidman's favor relieving it of responsibility for the damages sustained by its client. The Court of Appeals affirmed these instructions.

Seidman's Audit Responsibility. Cenco was a registered company under § 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 78*l*. Its securities were publicly traded on the New York and Pacific Coast Stock Exchanges. SEC Regulation S-X required that Cenco obtain annual audit reports

from an independent certified public accountant. The regulations specified that the audit reports had to state the auditor's opinion on the financial statements and whether he had followed Generally Accepted Auditing Standards ("GAAS"). The regulations also required the auditor to identify any matters to which he had taken exception. 17 C.F.R. §§ 210.2-02(b)-(d).

SEC Regulation S-X required the inclusion of the auditor's report in Cenco's annual Form 10-K filed with the SEC. 17 C.F.R. §§ 210.3-01(a), 210.3-02(a). In addition, SEC Rule 14a-3(b) required that the auditor's report accompany or precede any proxy statement from management to shareholders for a meeting to elect Cenco's directors. 17 C.F.R. § 240.14a-3(b).

In the 1960s, Cenco hired the national accounting partnership of Seidman & Seidman to render annual audit reports on the company's financial statements. Seidman continued to serve as Cenco's sole outside auditor during the years 1970 to 1975 when the inventory fraud occurred. Throughout those years, Seidman promised, in written contracts, to audit Cenco in accordance with GAAS and the SEC's regulations and to report any fraud that it encountered. (PX 1, 2).

Cenco paid nearly $4.8 million in fees to Seidman for its work in the years 1970-1975. (PX 7, 12, 21, 28, 30).

Seidman's Audits and Reports. The inventory fraud started in 1970 at the Cenco Medical/Health ("CMH") division. Cenco employees falsely increased the quantity of inventory shown in the company's books above the true quantity contained in its warehouses. Specific requirements of Seidman's audits included a reconciliation of the quantity of inventory shown on Cenco's books with the quantity actually contained in its warehouses. (PX 75, pp. 1597-99; Vol. 7, Tr. 1461; Vol. 9, Tr. 1944-46).

The falsified inventory totaled $20 million on Cenco's books by 1975, when, as the Seventh Circuit stated, the fraud was "discovered by a newly hired financial officer at Cenco who reported his suspicions to the Securities and Exchange

Commission." (App. A2). Seidman had not reported the fraud. Rather, in every year, Seidman issued an unqualified audit report stating that it had performed its audit in conformity with GAAS and that Cenco's financial statements "fairly presented" the financial condition and operating results of the company. (PX 4, 8, 13, 22, 29).

The jury returned general verdicts and made no specific findings concerning Seidman's adherence to GAAS or its knowledge of the fraud. However, the Seventh Circuit concluded that the evidence justified a finding of knowing concealment by Seidman:

> "Cenco's evidence tended to show that in the early stages of the fraud Seidman had been careless in checking Cenco's inventory figures and its carelessness had prevented the fraud from being nipped in the bud; that as the fraud expanded, Seidman's auditors became suspicious, but, perhaps to protect the very high fees that Seidman was getting from Cenco (about $1 million a year, which was 70 percent of Seidman's total billings), concealed their suspicions and kept giving Cenco a clean bill of health in their audit reports." (App. A3).

The Seventh Circuit concluded that the jury could have found Seidman "an intentional tortfeasor." (App. A11). The evidence showed that:

> "If Seidman had been a more diligent auditor, conceivably if it had been a more honest auditor, the fraud might have been nipped in the bud." (App. A10).

Reliance on Seidman's Reports. Cenco shareholders received Seidman's unqualified audit report before each annual meeting to elect directors as required by SEC Rule 14a-3(b). Cenco shareholders were then solicited by management for their proxies. Management's slate thereby was

elected throughout the period 1970-1975 based on financial statements that Seidman had certified.[1]

The Seventh Circuit recognized that "[n]ot all of the managers of Cenco were corrupt." (App. A2). The majority of Cenco's Board was independent and untainted by fraud: "Seven of the nine members of the board of directors were not in on the fraud . . ." (App. A2).[2] Cenco's honest directors and outside general counsel/secretary relied on Seidman's audit reports. (Vol. 15, Tr. 3236-37; Vol. 14, Tr. 3165).

Cenco's general counsel—a man, by Seidman's admission, of unquestioned integrity (Vol. 14, Tr. 3092)—relied on Seidman. He would have taken the matter to the Board of Directors and to the SEC if told about the fraud. (Vol. 14, Tr. 3093).

Attempting to understand Seidman's position on a company "inventory destruction" proposal, Cenco's general counsel questioned top Seidman partners about possible fraud. Despite these direct inquiries, Cenco's evidence showed that:

> "one partner in Seidman, asked by Cenco's general counsel (who was not in on the fraud) whether Seidman

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[1] Seidman's audit opinion (included in Cenco's annual report) was distributed to Cenco shareholders immediately before the mailing of management's proxy statement:

	Seidman Audit Letter in Annual Report	Proxy Statement	Scheduled Shareholders Meeting
1970:	7/24/70	8/21/70	9/24/70
1971:	7/21/71	8/17/71	9/23/71
1972:	7/20/72	8/17/72	9/28/72
1973:	7/19/73	8/23/73	9/27/72
1974:	8/1/74	8/23/74	9/24/73

(Annual reports: PX 5, 9, 14, 23, 30;
Proxy Statements: PX 6, 10, 15, 24, 31).

[2] Although the Seventh Circuit alludes to "evidence that [the directors] were negligent" (App. A2), no instruction was given to the jury concerning an allegation of Board negligence.

suspected anything, answered: 'No one suspects fraud. Dismiss that.' " (App. A3-4).

The Seidman partner in charge of the Cenco audit did suspect fraud at the time he made such statements. He testified that "fraud was a concern" and that he recognized Cenco management "might be lying and might be embarked on a fraudulent scheme." (Vol. 12, Tr. 2539-43). These suspicions were concealed.

Cenco paid Seidman millions in audit fees for improper work. Cenco also suffered large financial losses, including salaries and bonuses paid to the wrongdoers, overpayment of taxes, excessive incentive compensation payments, payment of dividends from overstated income, debt costs, and, ultimately, compensation paid to securities-holders injured by the fraud. These losses occurred because Cenco's Board of Directors was deceived about the company's true operating results during the period of the fraud.

District Court Proceedings. The inventory fraud became public in June, 1975, when Cenco's financial vice-president told the SEC about his suspicions of accounting irregularities. Thereafter, Cenco's top management was replaced with new employees having no prior connection to the company. [3]

Numerous lawsuits followed the public disclosure of the fraud. Present and former securities-holders of Cenco filed six class actions. These were consolidated by the Judicial Panel on Multidistrict Litigation in the Northern District of Illinois, Eastern Division. *In re Cenco Incorporated Securities*

[3] The District Court observed that Cenco's new management pursued "massive housecleaning procedures . . . with vigor." *SEC v. Cenco Incorporated,* 436 F.Supp. 193, 200 (N.D.Ill. 1977). The District Court therefore granted summary judgment for Cenco in the SEC's civil injunction suit. The court stated in a separate opinion that the SEC had "conceded new management's independence and good faith." Mem. op., at 2, *SEC* v. *Cenco Incorporated,* No. 76 C 3258 (N.D.Ill., Sept. 15, 1978). The SEC did not appeal this judgment in Cenco's favor.

Litigation, 434 F.Supp. 1237 (J.P.M.L. 1977). Cenco settled the claims of securities-holders who had purchased Cenco securities in reliance on the fraudulent financial statements by paying them $11 million in cash and notes.[4] The settlement was approved by the District Court. Cenco thereby satisifed its liability to public investors for the wrongdoing of its former employees.

In early 1977, Cenco filed cross-claims against Seidman and the former officers and employees who had perpetrated the inventory fraud. Cenco sought recovery from Seidman of its audit fees and the damages Cenco had incurred as a result of Seidman's failure to follow auditing practices that would have stopped the fraud.

The Related Criminal Proceedings. Federal indictments based on the inventory fraud were handed up in 1979 against certain former officers and employees of Cenco. Neither Cenco nor Seidman was a defendant in the criminal action, and new Cenco management assisted the U.S. Attorney's prosecution. Certain former CMH officials pled guilty. A jury convicted Cenco's former president and two former CMH officers of conspiracy, mail fraud, and securities fraud. The Court of Appeals affirmed the convictions of two on all counts and the conviction of the other for mail and securities fraud. *United States* v. *Read*, 658 F.2d 1225 (7th Cir. 1981).

The Jury Trial and Instructions. In the present case, the District Court ordered liability tried separately from damages. The jury heard evidence on liability during May and June, 1980. At the close of the evidence, the District

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[4]The securities-holders' complaints against Cenco included claims under the federal securities laws, common-law fraud, and a derivative count. The District Court dismissed the derivative count because of the plaintiffs' failure to make the demand on Cenco's Board of Directors required by Rule 23.1, Fed.R.Civ.P. (Tr. Pr. May 1, 1978, App. H).

Court granted Cenco's motion for a directed verdict on Seidman's cross-claims against Cenco.[5] The court also granted Seidman's motion for a directed verdict against Cenco on Cenco's claims against Seidman for aiding-abetting and conspiracy.

Cenco's remaining three claims for breach of contract, malpractice (negligence), and fraud were submitted to the jury. Over Cenco's objections, the District Court instructed the jury that (1) the acts and knowledge of corporate officers are attributed to Cenco under agency theory as a defense for the auditor Seidman, and (2) Cenco could not recover if it, through former officers, participated in or had knowledge of the fraud. Under these instructions, the fraud of former officers barred Cenco's recovery regardless of what Seidman had known of the fraud, what it had omitted from its audits in violation of GAAS, or what it had misrepresented to Cenco's shareholders and directors in its audit reports.

First, the District Court instructed the jury that the knowledge and wrongs of fraudulent employees was to be attributed to Cenco, applying a version of the *respondeat superior* doctrine:

> "[A]gents of a corporation are the officers and employees." (App. D5).
>
> "A corporation . . . is deemed to have knowledge of a fact or event whenever one of its agents, such as its officers or one of its other employees whose duties involve receiving information of such a fact or event, has such knowledge." (App. D5).

Second, the District Court gave causation and contributory negligence instructions that excused Seidman from liability if Cenco (now equated to its fraudulent former employees) had any concurrent fault contributing to its injuries. The

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[5] Seidman cross-claimed against Cenco for fraud, breach of contract, and violations of the Racketeer Influenced and Corrupt Organizations ("RICO") Act, 18 U.S.C. §§ 1961 *et seq.*

court instructed, for example, that Cenco could not recover for a breach of the audit contract unless it proved:

> " . . . (4) That Cenco suffered injury as a proximate result of Seidman's breach and *not as a result of its own conduct or omissions.*" (App. D6).[6]

Under this, plus the *respondeat superior* instruction, the fraud of employees that was a concurrent cause of Cenco's injuries barred its recovery from Seidman.

The District Court likewise eliminated Cenco's claim against Seidman for misrepresenting its audit work and findings in reports to the company's shareholders and directors:

> "[A] participant in a fraud cannot recover damages suffered as a result of the fraud from another participant in the fraud. Therefore, if you find that Cenco, through the conduct or acts of its officers or employees, was a participant in the fraud, you must find Seidman not liable to Cenco on its claim of fraudulent audit opinions in Cenco's third claim." (App. D16).

Comparable instructions were given as to each of Cenco's cross-claims. (App. D5, D8, D14-17).

Seidman's jury argument stressed the automatic discharge from liability resulting from these instructions. Seidman told the jury that, under the instructions, "*no matter what Seidman did,*" even "if you find Seidman was . . . at fault" and even "*assum[ing] Seidman lied,*" it was not liable to its client as long as even a single Cenco official was guilty of fraud. (Vol. 26, Tr. 5647, 5720, 5727-28). Seidman argued that the instructions dictated "that acts of management, acts of officers and directors, are acts of the Company." (Vol. 26, Tr. 5653).

Acting under these instructions, the jury returned general verdicts for Seidman.

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[6] Except as otherwise indicated, all emphases are added.

The Seventh Circuit Decision. The Seventh Circuit affirmed the judgment of the District Court dismissing all of Cenco's claims against Seidman.[7] The court recognized that the "main issue in the case" was the challenged jury instructions: "whether Seidman was entitled to use the wrongdoing of Cenco's managers as a defense against the charges of breach of contract, professional malpractice, and fraud." (App. A6). The court concluded that Seidman could do so.

The Seventh Circuit declined to address the question under federal law and discarded authorities from jurisdictions outside of Illinois. The court also recognized that the only pertinent Illinois authority, *Cereal Byproducts Co.* v. *Hall*, 8 Ill.App.2d 331, 132 N.E.2d 27 (1956), *aff'd*, 15 Ill.2d 313, 155 N.E.2d 14 (1958), rejected a rule exonerating auditors from liability because of fraud by their client's employees.

The Seventh Circuit distinguished *Cereal Byproducts* and grounded its decision on the "underlying objectives of tort liability"—compensation and deterrence. (App. A9). In terms of compensation, the court acknowledged that the "real beneficiaries" of any recovery by Cenco would be Cenco's shareholders. However, the Seventh Circuit concluded it would be "perverse" for present Cenco shareholders to recover, since these shareholders might include some of the former "corrupt officers."[8] (App. A9). The court acknowledged that "the other shareholders in this class *are innocent* in a sense" but denied them compensation because *"it is they who elected the board of directors* who managed Cenco during the fraud." (App. A9-10).

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[7]The Seventh Circuit also affirmed the dismissal of Seidman's RICO claim against Cenco. The court reversed the dismissal of Seidman's fraud and breach of contract claims against Cenco and remanded them for a new trial.

[8]The Court of Appeals overlooked the fact that the corrupt employees had been sued by the securities holders, Cenco, and Seidman.

The Seventh Circuit relied mainly on its concern for deterrence. The court acknowledged that "liability to Cenco [would] make Seidman, and firms like it, more diligent and honest in the future." (App. A10). However, the court concluded that Cenco's shareholders should bear the loss because "if owners of the corrupt enterprise are allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced." (App. A10-11).

The Court of Appeals did not discuss the implications of its decision for the federal goal of comprehensive investor protection. It declined to consider whether federal common law, rather than state tort law, should supply the rule of decision.[9]

REASONS FOR GRANTING THE WRIT

I. THE SEVENTH CIRCUIT'S DECISION UNDERMINES THE FEDERAL PLAN OF INVESTOR PROTECTION.

The Seventh Circuit's decision protects public accountants who voluntarily contract to perform audits under the federal securities laws but who breach that contract. The court below penalizes shareholders if they unknowingly choose dishonest managers, instead of penalizing the auditor who could be found an "intentional tortfeasor" for its improper audits and reports to shareholders. In contrast, federal law requires that auditors *assist* the shareholders in choosing their managers by examining and certifying management's representations in the financial statements.

The decision below contradicts the principal objective of the federal securities laws and defeats the purpose of SEC regulations prescribing the relationship between auditors and shareholders of publicly-traded companies.

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[9] The Court of Appeals probably chose Illinois law because Cenco maintains its headquarters in Chicago. Cenco is a Delaware corporation.

Investor protection is the principal objective of the Securities Exchange Act of 1934. This Court stated in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 195 (1976):

> "The 1934 Act was intended principally to *protect investors* against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose *regular reporting requirements* on companies whose stock is listed on national securities exchanges."

Section 13 of the 1934 Act authorizes the SEC, "as necessary for the proper protection of investors," to require registered § 12 companies like Cenco to file "such annual reports . . ., *certified* if required by the rules and regulations of the Commission *by independent public accountants* . . . ." 15 U.S.C. § 78m(a)(2).

Auditors of public companies play a central role under the 1934 Act. The auditor's report on financial statements provides an assurance of management's truthfulness to both (1) investors using the public securities markets and (2) investors evaluating their managers' performance during corporate proxy solicitations and elections.

Pursuant to statute, the SEC regulations require that public companies provide their shareholders with audited financial statements in their annual reports and in connection with proxies solicited for the election of corporate directors. SEC Rule 14a-3(b) expressly requires that shareholders have the benefit of an independent auditor's report when they decide to accept or reject management's nominees in corporate elections:

> "If the [proxy] solicitation is made on behalf of the issuer, and relates to an annual meeting of security holders at which directors are to be elected, each proxy statement . . . *shall be accompanied or preceded by an annual report to the security holders* as follows: (1) the report shall include, for the registrant and its subsidiaries consolidated, *audited balance sheets* . . . and

> *audited statements of income* and changes in financial position . . . prepared in accordance with Regulation S-X . . . ."

17 C.F.R. § 240.14a-3(b).[10] SEC Regulation S-X specifies that the "audited" statements must have the certification of an independent public accountant expressing his opinion under GAAS. 17 C.F.R. §§ 210.1-02(d), 210.2-02(b), 210.4-01(a)(1). These SEC regulations followed from Congress' recognition that

> "[i]n order that the stockholder may have adequate knowledge as to the manner in which his interests are being served, it is essential that he be enlightened . . . as to the financial condition of the corporation . . . ."

S.Rep. No. 792, 73d Cong., 2d Sess. 12 (1934).

The SEC, the courts, and the accounting profession all have recognized the role of the auditor in assuring the full disclosure necessary to protect investors. As early as 1936 the SEC held that the "[auditor's] certification gives a minimum of protection against untruths and half truths which otherwise would more easily creep into financial statements." *In the Matter of Cornucopia Gold Mines*, 1 S.E.C. 364, 367 (1936); *see In the Matter of McKesson and Robbins, Inc.*, 5 Fed.Sec.L.Rep. (CCH) ¶72,020 (ASR 19) (1940). The Second Circuit described the importance of the auditor's task and his power, if he acts irresponsibly, to inflict damage on public investors:

> "The role of the accounting and legal professions in implementing the objectives of the disclosure policy has increased in importance as the number and complexity of securities transactions has increased . . . . Breaches of professional responsibility jeopardize the achievement of

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[10] These SEC requirements were in force during the 1970-75 audits of Cenco. *See* 32 Fed. Reg. 1036 (Jan. 28, 1967), 23 Fed. Reg. 20963 (Dec. 29, 1967), 36 Fed. Reg. 8935 (May 15, 1971), and 39 Fed. Reg. 40768 (Nov. 20, 1974).

> the objectives of the securities laws and can inflict great damage on public investors."

Touche Ross & Co. v. *SEC*, 609 F.2d 570, 580-81 (2d Cir. 1979); *see SEC* v. *Transamerica Corp.*, 163 F.2d 511 (3rd Cir. 1947). The accounting profession itself recognizes and accepts its special role in investor protection. The American Institute of Certified Public Accountants has explained:

> "The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors in making economic decisions. This purpose includes *providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities.*"

AICPA, 3 *Professional Standards* (CCH) AC § 1024.01. The AICPA states, more particularly, that auditors must remain alert for "deliberate misrepresentation by management" in the financial statements. AICPA, *Statements on Auditing Standards*, § 110.05.[11]

Top Seidman partners agreed at trial. They testified that the audit serves as a "check" on the honesty of management. (Vol. 4, Tr. 776). The auditor is paid to be a "watchdog." (Vol. 3, Tr. 630). As one senior Seidman partner acknowledged, his firm was paid "a lot of money" by Cenco to be skeptical and to "make sure those people [in Cenco's management] were telling the truth." (Vol. 12, Tr. 2669-70).

The Seventh Circuit excused Seidman from liability because an event occurred (management fraud) that Seidman had agreed to consider and, if detected, to report. The

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[11] The leading auditing treatise confirms that "[t]he function of an auditor's opinion on financial statements is to lend credibility to management's representations." *Montgomery's Auditing* 13 (9th ed. 1975).

Seventh Circuit did so because it wished to "deter" shareholders from selecting dishonest managers.

This result puts the cart before the horse. The federal securities regulations require audit opinions *so that* shareholders can make an informed decision in choosing their managers. The resulting contradiction between the decision below and the statutory objective is grave.

This Court should issue the writ to correct the Seventh Circuit's decision immunizing auditors from breach of their duties under contracts mandated by federal law.

II. THE JURY INSTRUCTIONS, AFFIRMED BY THE SEVENTH CIRCUIT, CONFLICT WITH HOLDINGS OF THIS COURT AND OTHER COURTS OF APPEALS.

The District Court's jury instructions rested on a presumption that public auditors deal with their corporate client like an ordinary third party having no special duties. The instructions on agency overlooked the fact that the auditor assumes a unique duty to investigate his client's management and to report what he finds. The instructions thus ignored the core reason for auditing prescribed both by federal regulation and by the accounting profession itself. The Seventh Circuit's affirmance of these instructions conflicts directly with holdings of this Court and other Courts of Appeals concerning the proper use of agency theory to attribute one person's knowledge or fault to another.

The Seventh Circuit recognized the pivotal importance of the District Court's agency instructions:

> "The judge . . . instructed the jury that the acts of a corporation's employees are the acts of the corporation itself if the employees were acting on the corporation's behalf. If this instruction was correct, then the instructions which allowed the jury to consider Cenco's misconduct as a defense to Seidman's alleged wrongdoing were proper." (App. A8).

The Court of Appeals approved these agency instructions without comment on the unique role of Seidman, as a public auditor, under both its contract and the law.

The Seventh Circuit's approval of the agency instructions conflicts with the holding of this Court in *Mutual Life Ins. Co.* v. *Hilton-Green*, 241 U.S. 613 (1916). The Court held in *Hilton-Green* that an agent's knowledge will not be imputed to his principal where the third-party, who asserts the imputation, knew he should not blindly rely on the agent's fidelity:

> "The general rule which imputes an agent's knowledge to the principal is well established. The underlying reason for it is that *an innocent third party* may properly presume the agent will perform his duty and report all facts which affect the principal's interest. But *this general rule does not apply when the third party knows there is no foundation for the ordinary presumption*—when he is acquainted with circumstances plainly indicating that the agent will not advise his principal. *The rule is intended to protect those who exercise good faith and not as a shield for unfair dealing.*"

241 U.S. at 622-23.

The theory of agency-imputation cannot apply to auditors who undertake an independent examination of management's (the agent's) credibility as a basis to inform the shareholders (the principal) concerning the financial statements. Under GAAS, auditors may not presume that the client's managers are reporting accurately. To give Seidman the defense of agency-imputation instructions, as did the courts below, fundamentally contradicts *Hilton-Green*.

Other Courts of Appeals have stated that the fictions of agency law should not be applied indiscriminately to corporate relationships. *Shell* v. *Hensley*, 430 F.2d 819, 826 (5th Cir. 1970); *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968) *(en banc), cert. denied*, 395 U.S. 906 (1969). These other Circuits have held, specifically, that agency theory should

not be allowed as a defense against corporate claims involving a breach of duties owed to the corporation for the benefit of its shareholders.

Thus, the Second Circuit refused to impute the knowledge of fraudulent officers and directors to their corporate employer in a derivative case that involved claims by the company against its outside accountants and investment firm. *Goldberg* v. *Meridor*, 567 F.2d 209, 215-16 (2d Cir.), *cert. denied*, 434 U.S. 1069 (1977). The same court held in *Maldonado* v. *Flynn*, 597 F.2d 789, 793-94 (2d Cir. 1979), that imputation of knowledge to the corporation depends on knowledge by *"a disinterested majority of the board possessing authority to act and fully informed of all relevant facts,"* and even then, imputation may not result if the "directors cannot be relied upon to represent the interests of shareholders fairly." *See IIT, An International Investment Trust* v. *Cornfeld*, 619 F.2d 909, 918 (2d Cir. 1980).

Similarly, the Fifth Circuit reversed a summary judgment dismissing derivative claims in *Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), *cert. denied*, 449 U.S. 820 (1980), where shareholders asserted a corporate fraud claim under SEC Rule 10b-5 against both corporate insiders and outsiders. The court refused to permit defenses based on agency-imputation theory even if *all* of the company's directors were shown to have had knowledge of the alleged fraud:

> "The requisite 'deception' is provided if the disinterested directors *or* shareholders are misled, because they are fairly viewed as standing in the place of the corporate entity under these circumstances."

606 F.2d at 613.

A corporation's claims against its fraudulent or negligent auditor fall squarely within these precedents. The auditor owes a duty directly to his corporate client for the benefit of its public shareholders. The auditor's duty is concurrent with the duties of management; indeed, his duty expressly

includes a responsibility for examining the credibility and stewardship of management. Except for the decision below, no federal or state decision has excused an auditor's breach of professional duty under agency-imputation principles on the grounds that management fraud has occurred.[12]

This Court should issue the writ to resolve the conflict between the decision below and the precedents of this Court and other Courts of Appeals on the use of agency rules as a defense for breach of duties owed to the shareholder-principals of a corporation.

III. THE SEVENTH CIRCUIT'S REJECTION OF THE PRINCIPLES OF FEDERAL COMMON LAW CONFLICTS WITH PRECEDENTS OF THIS COURT.

The Seventh Circuit refused to consider Cenco's claims as a subject of federal common law. The court below concluded that Cenco's claims should be treated solely within the strictures of state tort law. This approach ignored the audit contract that was the basis of Seidman's duties.[13]

In contrast to the Seventh Circuit's decision, consideration of the audit contract leads directly to the requirements and policies of federal law from which the contract arose. Such consideration requires that rules of liability under public-company audit contracts be developed as a matter of uniform

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[12] Accountants' liability cases from England and from American state courts have held auditors liable to their clients without attributing employee fraud to the client as a defense. No such case supports the decision below. However, because the auditor's duty in this case arises from federal law, the earlier accountants' cases are not discussed in this Petition.

[13] The Seventh Circuit first rejected federal jurisdictional bases for Cenco's claims. It then asserted that Illinois tort law would apply. The court gave no consideration to the audit contract as a basis for Seidman's liability and made no determination, as required by *Klaxon Co.* v. *Stentor Electric Mfg. Co.*, 313 U.S. 487 (1941), whether Illinois would apply some other state's laws under Illinois choice-of-law principles.

federal common law. The Seventh Circuit's refusal to proceed under federal common law conflicts with the principles set forth by this Court in *Banco Nacional de Cuba* v. *Sabbatino*, 376 U.S. 398 (1964); *Illinois* v. *City of Milwaukee*, 406 U.S. 91 (1972); and this Term in *Jackson Transit Authority* v. *Local Division 1285, Amalgamated Transit Union*, —U.S.—, 50 U.S.L.W. 4603 (June 7, 1982).

The Court explained in *City of Milwaukee* that federal common law should be fashioned to meet overriding needs for national uniformity:

> "As Mr. Justice Harlan indicated for the Court in *Banco Nacional de Cuba* v. *Sabbatino*, 376 U.S. 398 (1964), where there is an overriding need for a uniform rule of decision or where the controversy touches basic interests of federalism, we have fashioned federal common law."

406 U.S. at 105 n.6; *see also Machinists* v. *Central Airlines, Inc.*, 372 U.S. 682, 691-92 (1963); *Clearfield Trust Co.* v. *United States*, 318 U.S. 363, 367 (1943).

The appropriateness of applying federal common law usually turns on congressional intent. *See, e.g., Jackson Transit, supra*, 50 U.S.L.W. at 4604. The federal securities statutes which underlie the SEC's audit requirements have the express purpose of achieving national uniformity. The 1934 Act declares Congress' intent to protect a national public interest in the securities markets and in the reporting requirements delegated to the SEC:

> "[T]ransactions in securities as commonly conducted upon securities exchanges are affected with a *national public interest* which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including . . . to *require appropriate reports* . . . ."

Pub.L. 73-291, § 2; 48 Stat. 881 (1934).

Congress specifically intended the SEC to establish uniform national accounting and reporting methods for publicly traded companies. In considering § 13(b) of the 1934 Act, now 15 U.S.C. § 78m(b), under which the SEC requires audited financial statements, Congress sought to achieve national uniformity. Senator Duffy offered an amendment to § 13(b) that would have required that SEC Rules on accounting methods not conflict with those of any state. 78 Cong.Rec. 8567 (1934). Senator Fletcher, the Senate sponsor of the 1934 Act, opposed the amendment:

> "We oppose the amendment on the ground that so many states require so many different rules and regulations that it would be impossible to know just what the amendment would cover."

78 Cong. Rec. 8567. Senator Byrnes of the sponsoring committee noted that "*the object of this section [§ 13] is to make for uniformity.*" 78 Cong.Rec. 8568. The amendment was defeated.[14]

Rather than promoting national uniformity in an area of declared national interest, however, the Seventh Circuit's ruling encourages divergent rules in different states depending on each jurisdiction's respect for audit contracts. The responsibilities of public-company auditors could simply turn on the vagaries of varying state tort rules. This result would expose public investors to differing risks according to such fortuities as the location of a corporate headquarters or the location of the accountant's business office.

This Court has identified at least two situations when federal common-law should apply. Both are present here.

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[14] Congress more recently reiterated its goal of uniform national securities markets. Thus, in enacting the Securities Acts Amendments of 1975, Pub.L. 94-29, 89 Stat. 97 (1975), Congress declared that "the securities markets are an important national asset" (§ 11A(a)(1)(A); 89 Stat. 111) and stated its objective to "remove impediments to and perfect the mechanisms of a national market system for securities . . . ." (§ 2, 89 Stat. 97).

First, the Court has applied federal common law to the enforcement of contracts contemplated by federal statutes. In recounting the significance of its decisions in *Machinists* v. *Central Airlines, Inc.*, 372 U.S. 682 (1963); *Norfolk & Western R. Co.* v. *Nemitz*, 404 U.S. 37 (1971); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11 (1979); and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the Court stated earlier this Term:

> "[T]hese decisions demonstrate that *suits to enforce contracts contemplated by federal statutes* may set forth federal claims and that private parties in appropriate cases may sue in federal court to enforce contractual rights created by federal statutes."

Jackson Transit Authority, supra, 50 U.S.L.W. at 4605 .

Seidman's audit contracts with Cenco were not only contemplated, but also mandated, by SEC Regulation S-X, SEC Rule 14a-3, and other regulations promulgated under § 13 of the Securities Exchange Act of 1934.

Second, the Court has emphasized the need for a uniform federal rule to govern interstitial issues within a complex of federal regulation:

> "[T]he inevitable incompleteness presented by all legislation means that *interstitial federal lawmaking is a basic responsibility of the federal courts.* 'At the very least, effective Constitutionalism requires recognition of power in federal courts to declare, as a matter of common law or "judicial legislation," rules which may be necessary to fill in interstitially or otherwise effectuate the statutory patterns enacted in the large by Congress. In other words, it must mean *recognition of federal judicial competence to declare the governing law in an area comprising issues substantially related to an established program of government operation.*' "

United States v. *Little Lake Misere Land Co.*, 412 U.S. 580, 593 (1973), quoting Mishkin, *The Variousness of "Federal Law":*

Competence and Discretion in the Choice of National and State Rules for Decision, 105 U.Pa.L.Rev. 797, 800 (1957).

The enforcement of Seidman's audit and reporting obligations presents an interstitial issue within the federal securities laws. The securities statutes and SEC regulations establish a comprehensive program of federal regulation in which the responsibilities of public-company auditors play a central role. A federal common-law rule should govern those responsibilities.

Under this Court's precedents, a federal common-law rule is required to govern the important responsibilities of public-company auditors. The Seventh Circuit's decision conflicts with these precedents.

First, the Court's decision denies the enforceability of the federally-mandated contract which created Seidman's audit responsibilities. The SEC required that contract to meet a important federal goal. When the Seventh Circuit refused to enforce Seidman's audit contract, it pulled the teeth from the SEC's requirement.

Second, rather than fashioning an interstitial rule consistent with federal law purposes, the decision below espouses a rule that contradicts federal policy by denying protection to the shareholders who are the very persons whom the SEC audit requirements seek to protect. The Seventh Circuit's decision denies a client in Cenco's position any remedy against its auditor, even the auditor who, as here, may be found to be an "intentional tortfeasor." It holds that the client's innocent shareholders must bear the loss.

The Seventh Circuit's use of "management fraud" to protect auditors from fraud liability to their client also protects them from negligence liability to anyone who relies on their audit reports. In doing so, it opens a wide gap in the federal scheme of investor protection. This Court has held that public shareholders who suffer loss in securities transactions may not, under SEC Rule 10b-5, hold the auditor responsible for negligent audits. There must be a showing of intent to defraud. *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. 185. *See also Glanzer* v. *Shepherd,* 233 N.Y. 236, 135 N.E. 275 (1922)

(equivalent common-law rule). The Seventh Circuit's decision now means that *no one* — neither the shareholder with trading losses nor the client — can hold the auditor accountable for negligence and malpractice. Shareholders must simply bear the loss. In short, while SEC regulations require a proper GAAS audit, the auditors can fail to perform, walk away with the fees, and saddle shareholders with the loss. This result conflicts with basic federal policy.

This Court should issue the writ to fulfill the need for a uniform federal rule of decision where the Seventh Circuit's tort decision frustrates the purpose of the federal securities regulations and the important national interest in uniformity of investor protection.

CONCLUSION

The Court of Appeals conceded that the jury could have found Seidman an "intentional tortfeasor" who violated its audit responsibilities "to protect its very high fees." The victims of Seidman's wrongdoing were "innocent shareholders." As between admittedly innocent shareholders and a wrongdoing auditor, the Seventh Circuit protected the wrong party. This anomalous result, standing alone, justifies review.

The national importance of this question reinforces the need for review. The Seventh Circuit refused to enforce an audit contract required by federal law. The court did so for reasons that squarely contradict the federal objective of investor protection that underlies the SEC's audit requirements. Public auditors serve to help shareholders make informed decisions about management—not exploit management's wrongs as an excuse for the auditor's own failure to do his job and report the truth. State tort law should not defeat a federal policy which Congress, the SEC, and the courts have tried to advance for nearly fifty years. A uniform, national rule should govern the responsibilities of public-company auditors who undertake their role to fulfill the mandate of federal law.

Petitioner, Cenco Incorporated, therefore respectfully requests that a writ of certiorari issue to review the judgment of the Court of Appeals for the Seventh Circuit.

DATED: July 29, 1982

Respectfully submitted,

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APPENDICES

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 81-2126, 81-2264

CENCO INCORPORATED,

Cross-Claimant-Appellant,
Cross-Defendant-Appellee,

v.

SEIDMAN & SEIDMAN,

Cross-Defendant-Appellee,
Cross-Claimant-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 75-C-2227—John Powers Crowley and Marvin E. Aspen, *Judges.*

ARGUED FEBRUARY 22, 1982—DECIDED MARCH 26, 1982

Before BAUER, WOOD, and POSNER, *Circuit Judges.*

POSNER, *Circuit Judge.* We consider in this case the standards under the common law of Illinois governing the liability of independent auditors for failing to detect fraud by the management of the company audited; the standing of auditors under the RICO statute (Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961 *et seq.*) to sue such a company for damages; and—*sua sponte*, as we are obliged to do—questions of federal subject-matter jurisdiction.

Between 1970 and 1975, managerial employees of Cenco Incorporated engaged in a massive fraud. The fraud began in Cenco's Medical/Health Division but eventually

spread to the top management of Cenco, and by the time it was unmasked the chairman and president of Cenco plus a number of vice-presidents and other top managers were deeply involved. Not all the managers of Cenco were corrupt, however. Seven of the nine members of the board of directors were not in on the fraud, although there is evidence that they were negligent in allowing it to flourish undetected beneath their noses. The fraud was eventually discovered by a newly hired financial officer at Cenco who reported his suspicions to the Securities and Exchange Commission. Cenco's independent auditor throughout the period of the fraud, the accounting partnership of Seidman & Seidman, either never discovered the fraud or if it did failed to report it.

The fraud primarily involved the inflating of inventories in the Medical/Health Division far above their actual value. This increased the apparent worth of Cenco and greatly increased the market price of its stock (when the fraud was unmasked, the market price plummeted by more than 75 percent). The inflated stock was used to buy up other companies on the cheap. Cenco further benefited from the fraud by being able to borrow money at lower rates than if its inventories had been honestly stated and by getting its insurers to pay inflated claims for inventory lost or destroyed, since Cenco's insurance claims were based on inflated rather than actual inventory values. Thus, those involved in the fraud were not stealing from the company, as in the usual corporate fraud case, but were instead aggrandizing the company (and themselves) at the expense of outsiders, such as the owners of the companies that Cenco bought with its inflated stock, the banks that loaned Cenco money, and the insurance companies that insured its inventories.

The unmasking of the fraud led to the filing of a class action in federal district court against Cenco, its corrupt managers, and Seidman & Seidman. The class was composed of purchasers of Cenco stock during the period of the fraud, when the stock price was inflated. The suit charged the defendants with having violated various federal securities laws and SEC rules, notably Rule 10b-

5, and common law strictures against fraud and related misconduct. Cenco—now under clean management—filed a cross-claim under Rule 13(g) of the Federal Rules of Civil Procedure against its codefendant Seidman & Seidman, alleging that Seidman was liable to Cenco under both federal and state common law for having failed to prevent the fraud by Cenco's managers. Seidman filed its own Rule 13(g) cross-claim against Cenco, alleging that Seidman had been one of the victims of Cenco's fraud and was thus entitled to damages from Cenco under the RICO statute, state common law, and principles of indemnity.

Cenco's and Seidman's cross-claims against each other were set for trial together. The trial began on May 8, 1980, one day before the last settlement in the class action, which happened to be the settlement with Seidman (for $3.5 million), was submitted to the district judge for his approval. The trial was separated into liability and damages phases; liability, of course, was tried first. At the close of all the evidence but before submitting the case to the jury, the judge granted a directed verdict in favor of Cenco dismissing Seidman's cross-claim and a directed verdict in favor of Seidman on those counts in Cenco's cross-claim that alleged that Seidman had aided and abetted the fraud of Cenco's managers and had actually joined their conspiracy to defraud.

The case went to the jury on the three remaining counts in Cenco's cross-claim, alleging respectively breach of contract, professional malpractice (negligence), and fraud. Cenco's evidence tended to show that in the early stages of the fraud Seidman had been careless in checking Cenco's inventory figures and its carelessness had prevented the fraud from being nipped in the bud; that as the fraud expanded, Seidman's auditors became suspicious, but, perhaps to protect the very high fees that Seidman was getting from Cenco (about $1 million a year, which was 70 percent of Seidman's total billings), concealed their suspicions and kept giving Cenco a clean bill of health in their audit reports; that one partner in Seidman, asked by Cenco's general counsel (who was not in on the fraud) whether Seidman suspected anything, answered: "No one suspects fraud.

Dismiss that." Seidman's evidence tended to show, to the contrary, that Seidman had diligently attempted to follow up all signs of fraud but had been thwarted by the efforts of the large group of managers at all levels at Cenco who were in on the fraud to prevent Seidman from learning about it.

The jury found for Seidman on all three counts. Cenco appeals both from the dismissal of its aiding and abetting and conspiracy counts and from the judgment entered against it on the jury's verdict, which it contends was based on erroneous instructions. Seidman appeals from the dismissal of the RICO and common law counts in its cross-claim. Several other rulings by the district judge are also before us on these cross-appeals.

We begin our analysis with the directed verdict in favor of Seidman on Cenco's aiding and abetting and conspiracy counts. Like the rest of Cenco's cross-claim these counts are based solely on Illinois law. Although the cross-claim purports to base federal jurisdiction on 28 U.S.C. § 1331, the general federal-question jurisdictional statute, and on section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa, a general conferral of federal jurisdiction over cases arising under the federal securities laws, these statutes are not pertinent to Cenco's cross-claim since Cenco does not allege any violation of a federal statute or rule. One sentence in Cenco's reply brief in this court, citing an interstate pollution case, asks us to create a rule of federal common law to govern auditors' liabilities, but we decline so casual an invitation to so ambitious an exercise of judicial creativity.

The only basis for federal jurisdiction over Cenco's cross-claim is the concept of ancillary jurisdiction, which allows state-law claims to be litigated in federal court in some circumstances even if the requirements of diversity jurisdiction are not met (as they are not here). A Rule 13(g) cross-claim is within the ancillary jurisdiction of the federal courts if the main claim is within their jurisdiction, as the claim of the class plaintiffs was; and the dismissal of the main claim does not require the

dismissal of the cross-claim, at least if the main claim is not dismissed before the trial of the cross-claim. See *Federman v. Empire Fire & Marine Ins. Co.*, 597 F.2d 798, 811 (2d Cir. 1979). Since the class action settlement was not approved by the district court until June 30, 1980, which was after the start of the trial on the cross-claims, and did not become final until upheld by this court a year later *sub nom. Helfand v. Fromkin*, No. 80-2091 (unpublished order, 7th Cir. July 13, 1981), the district court had jurisdiction to adjudicate Cenco's cross-claim against Seidman even though it was based purely on state law and Cenco and Seidman are not citizens of different states.

Coming to the merits, we can easily dispose of the charge that Seidman aided and abetted the fraud by Cenco's managers. There is no tort of aiding and abetting under Illinois law or, so far as we know, the law of any other state; all the cases that Cenco has cited with regard to this count are criminal cases. This is not a gap in tort law. Anyone who would be guilty in a criminal proceeding of aiding and abetting a fraud would be liable under tort law as a participant in the fraud, since aider-abettor liability requires participation in the criminal venture. E.g., *United States v. Beck*, 615 F.2d 441, 448-49 (7th Cir. 1980). The only utility of a separate tort of aiding and abetting in the commission of a tort would be to give plaintiffs' lawyers one more charge to fling at the jury in the hope that if enough charges are made the jury may accept at least one. In any event, creating a new Illinois tort is something for the Illinois courts or legislature to do rather than the federal courts.

We have much the same reaction to the conspiracy count, though the fact that Seidman does not argue that there is no tort of conspiracy makes us diffident about disposing of it on this ground. Tort law, unlike criminal law, does not punish "inchoate," which is to say purely preparatory, conduct; for wrongdoing to be actionable as a tort there must be an injury, see, e.g., *Town of Thornton v. Winterhoff*, 406 Ill. 113, 119, 92 N.E.2d 163, 166 (1950), as Cenco itself argues in defending the dismissal of Seidman's cross-claim. So while some torts, such as boycotts in restraint of trade, by their nature involve

concerted activity, there is no basis in common law thinking for a tort of conspiracy to commit a tort. If there is a conspiracy and it fails, there is no injury and hence no tort liability; if it succeeds, the damages are fully recoverable in an action on the underlying tort. See Prosser, Handbook of the Law of Torts 293 (4th ed. 1971).

In any event, Cenco could not have been prejudiced by the judge's dismissal of the conspiracy count. The judge allowed Cenco's fraud count to go to the jury, and Cenco has pointed us to no evidence that pertained only to Seidman's alleged participation in the conspiracy and not to its alleged participation in the fraud as well. In fact the fraud *was* a conspiracy, a conspiracy among numerous managers at Cenco; and by allowing the jury to consider whether Seidman had participated in the fraud the judge necessarily allowed the jury to consider whether Seidman had participated in a conspiracy to defraud. If it was error to withdraw the conspiracy count from the jury, which we doubt, it was harmless error.

This brings us to the main issue in the case—whether the district judge gave erroneous instructions to the jury. The challenged instructions relate to the question whether Seidman was entitled to use the wrongdoing of Cenco's managers as a defense against the charges of breach of contract, professional malpractice, and fraud. Despite the plurality of charges it is one question because breach of contract, negligence, and fraud, when committed by auditors, are a single form of wrongdoing under different names. The contract in question here (really a series of contracts) consists of the letters between Seidman and Cenco outlining the terms of Seidman's annual retention to audit Cenco's books. The material part of the letters is the incorporation by reference of general accounting standards which, so far as pertinent to this case, require the auditor to use his professional skill to follow up any signs of fraud that he discovers in the audit. The tort of negligence in the context of auditing is likewise a failure to use professional care and skill in carrying out an audit. And if such care and skill are not used, then the audit reports to the

client will contain misrepresentations, either negligent or, if the auditor knows that the representations in the reports are untruthful or is indifferent to whether or not they are truthful, fraudulent.

Because these theories of auditors' misconduct are so alike, the defenses based on misconduct of the audited firm or its employees are also alike, though verbalized differently. A breach of contract is excused if the promisee's hindrance or failure to cooperate prevented the promisor from performing the contract. See Restatement (Second) of Contracts § 245 (1979). The corresponding defense in the case of negligence is, of course, contributory negligence. We need not consider to what extent that defense in an auditors' liability case may have been modified by the recent decision of the Illinois Supreme Court in a personal-injury case to replace contributory by comparative negligence. The court held that this change was not to apply to trials begun prior to the date of the decision, which was June 8, 1981. *Alvis v. Ribar*, 85 Ill. 2d 1, 28, 421 N.E.2d 886, 898 (1981). The decision whether to make a change of law prospective or retrospective, and if the former as of what date, is a matter of substance within the broad meaning assigned the term in cases (e.g., *Walker v. Armco Steel Co.*, 446 U.S. 740, 751 (1980)) following *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). Hence it binds the federal courts in applying state law, whether in a diversity suit or in any other suit where, as here, state law supplies the rule of decision.

Negligence is not a defense to an intentional tort such as fraud. E.g., *Mother Earth, Ltd. v. Strawberry Camel, Ltd.*, 72 Ill. App. 3d 37, 52, 390 N.E.2d 393, 405 (1979). But a participant in a fraud cannot also be a victim entitled to recover damages, for he cannot have relied on the truth of the fraudulent representations, and such reliance is an essential element in a case of fraud. See, e.g., *Broberg v. Mann*, 66 Ill. App. 2d 134, 139, 213 N.E.2d 89, 92-93 (1965). If the misrepresentation is negligent rather than intentional, contributory negligence plays the same role it would play in an ordinary negligence case. See Prosser, *supra*, at 706.

The jury instructions in this case stated these defenses accurately, but Cenco contends that the instructions should not have been given, because they related not to Cenco's conduct but to that of its managers. The judge was aware of the distinction but instructed the jury that the acts of a corporation's employees are the acts of the corporation itself if the employees were acting on the corporation's behalf. If this instruction was correct, then the instructions which allowed the jury to consider Cenco's misconduct as a defense to Seidman's alleged wrongdoing were proper.

To determine the correctness of the instruction requires us to decide in what circumstances, if any, fraud by corporate employees is a defense in a suit by the corporation against its auditors for failure to prevent the fraud. Illinois precedent allows us to reject one extreme position on this question, which is that the employee's fraud is always attributed to the corporation by the principle of respondeat superior. This position, which would exonerate auditors from all liability for failing to detect and prevent frauds by employees of the audited company, was rejected in *Cereal Byproducts Co. v. Hall*, 8 Ill. App. 2d 331, 132 N.E.2d 27 (1956), where a company's independent auditors were held liable for negligently failing to detect embezzlement by the company's bookkeeper. Auditors are not detectives hired to ferret out fraud, but if they chance on signs of fraud they may not avert their eyes—they must investigate. The references to keeping an eye out for fraud that appear in the accounting standards incorporated (by reference) in the retention letters between Cenco and Seidman would have little point if not interpreted to impose a duty on auditors to follow up any signs of fraud that come to their attention.

But this does not tell us what the result should be if the fraud permeates the top management of the company and if, moreover, the managers are not stealing from the company—that is, from its current stockholders—but instead are turning the company into an engine of theft against outsiders—creditors, prospective stockholders, insurers, etc. On this question the Illinois cases on auditors' liability provide no guidance. In

fact, to our knowledge the question has never been the subject of a reported case. *Leeds Estate, Bldg. & Inv. Co. v. Shepherd*, 36 (L.R.) Ch. D. 787, 802, 809 (1887), described by Cenco in its main brief as "the one squarely applicable common law decision on accountants' liability," is nothing of the sort. The auditor in that case had failed to discover that the company's manager, by misrepresenting the profits of the company, had caused the company to pay out dividends, directors' fees, and bonuses for himself—all in violation of the charter—as a result of which the company went broke. This was stealing from, not for, the company.

In predicting how the Illinois courts might decide the present case, we assume they would be guided by the underlying objectives of tort liability. Those objectives are to compensate the victims of wrongdoing and to deter future wrongdoing. With regard to the first, we must refine our earlier statement that the "victim" of Seidman's alleged laxity was Cenco Incorporated. A corporation is a legal fiction. The people who will receive the benefits of any judgment rendered in favor of Cenco on its cross-claim against Seidman are Cenco's stockholders, comprising people who bought stock in Cenco before the fraud began, people who bought during the fraud period and either sold afterwards when the stock price fell or continue to hold the stock at a loss, and people who bought after the fraud was unmasked. A judgment in favor of Cenco on its claim against Seidman would not differentiate among these classes, but would benefit every stockholder as of the date of the judgment (or the date when a judgment was anticipated with some precision) in proportion to the number of shares he owned.

Once the real beneficiaries of any judgment in favor of Cenco are identified, it is apparent that such a judgment would be perverse from the standpoint of compensating the victims of wrongdoing. Among the people who bought stock in Cenco before the fraud began are the corrupt officers themselves. To the extent they are still stockholders in the company, they would benefit pro rata from a judgment in favor of Cenco. The other stockholders in this class are innocent in a sense, but of

course it is they who elected the board of directors that managed Cenco during the fraud. The people who bought during the fraud period and either sold at a loss or continue to hold at a loss are the plaintiffs in the recently settled class action in which both Cenco and Seidman were defendants. Seidman has already paid $3.5 million to them. Those who continue to own stock in Cenco (as distinct from those who sold at a loss) would receive additional compensation if Cenco prevailed in this action against Seidman. This is not to say they would be overcompensated; but it seems odd that the same shareholders should be able to recover damages from Seidman twice for the same wrong—once directly and once, in this suit, indirectly. Finally, the shareholders who bought after the fraud was unmasked lost nothing. The unmasking of the fraud caused the price of Cenco's stock to be bid down to reflect not only the true value of its inventories but also any anticipated injury to the company as a result of the fraud.

Because of shareholder turnover, there is always a potential mismatch between the recovery of damages by a corporation and the compensation of the shareholders actually injured by the wrong for which the damages were awarded. It is simply a more dramatic mismatch in this case than usual.

From the standpoint of deterrence, the question is whether the type of fraud that engulfed Cenco between 1970 and 1975 will be deterred more effectively if Cenco can shift the entire cost of the fraud from itself (which is to say, from its stockholders' pockets) to the independent auditor who failed to prevent the fraud. We think not. Cenco's owners—the stockholders—hired managers (directly, in the case of the president and chairman, who were both members of the board of directors, indirectly in the case of the others) who turned out to be thoroughly corrupt and to corrupt the corporation so thoroughly that it caused widespread harm to outsiders. If Seidman had been a more diligent auditor, conceivably if it had been a more honest auditor, the fraud might have been nipped in the bud; and liability to Cenco will make Seidman, and firms like it, more diligent and honest in the future. But if the owners of the corrupt enterprise are

allowed to shift the costs of its wrongdoing entirely to the auditor, their incentives to hire honest managers and monitor their behavior will be reduced. While it is true that in a publicly held corporation such as Cenco most shareholders do not have a large enough stake to want to play an active role in hiring and supervising managers, the shareholders delegate this role to a board of directors, which in this case failed in its responsibility. And not all of Cenco's shareholders were "little people." During the period of the fraud Curtiss-Wright Corporation owned between 5 and 16 percent of Cenco's common stock and had its own accounting firm conduct a study of Cenco's operations—without discovering the fraud.

Thus, not only were some of Cenco's owners dishonest (and, to repeat, to the extent they still own stock in Cenco they would benefit from any judgment in Cenco's favor against Seidman), but the honest owners, and their delegates—a board of directors on which dishonesty and carelessness were well represented—were slipshod in their oversight and so share responsibility for the fraud that Seidman also failed to detect. In addition, the scale of the fraud—the number and high rank of the managers involved—both complicated the task of discovery for Seidman and makes the failure of oversight by Cenco's shareholders and board of directors harder to condone.

Cenco tries to draw a sharp contrast between an innocent Cenco and a Seidman that was (or so the jury could have found) an intentional tortfeasor. But if Cenco may be divorced from its corrupt managers, so may Seidman from the members and employees of the firm who suspected the fraud. If Seidman failed to police its people, Cenco failed as or more dramatically to police its own.

Furthermore, we must assume that Cenco's corrupt managers were acting for the benefit of the company, not against it as in the *Cereal Byproducts* case. The jury was instructed that it could attribute the fraud of Cenco's managers to Cenco only if it found that the managers had been acting on Cenco's behalf, and the verdict for Seidman implies that the jury either so found

or found that Seidman had not even committed a prima facie breach of duty to Cenco. The former assumption is more favorable to Cenco.

Fraud on behalf of a corporation is not the same thing as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims; their equities vis-à-vis a careless or reckless auditor are therefore strong. But the stockholders of a corporation whose officers commit fraud for the benefit of the corporation are beneficiaries of the fraud. Maybe not net beneficiaries, after the fraud is unmasked and the corporation is sued—that is a question of damages, and is not before us. But the primary costs of a fraud on the corporation's behalf are borne not by the stockholders but by outsiders to the corporation, and the stockholders should not be allowed to escape all responsibility for such a fraud, as they are trying to do in this case.

We need not go so far as to predict that the Illinois courts would hold that in any action by a corporation against its auditors an employee's fraud intended to benefit the company rather than the employee at the company's expense will be attributed to the corporation, however lowly the employee. It is true that the lower down the employee is in the company hierarchy, the less likely he is to commit fraud for rather than against the company. But there are overzealous employees at every level—many a corporation has paid heavy damages for antitrust violations committed by low-level sales managers who thought they were acting in the company's best interests as well as their own—and we think it premature as well as unnecessary to decide that an auditor is never liable for the frauds of loyal but misguided company employees that he could have prevented by taking care. But here the uncontested facts show fraud permeating the top management of Cenco. In such a case the corporation should not be allowed to shift the entire responsibility for the fraud to its auditors.

Hence the challenged jury instruction was proper in the circumstances; and having thus disposed of Cenco's cross-claim, we turn to Seidman's. The indemnity count

in Seidman's cross-claim was dismissed on the basis of this court's decision in *Heizer Corp. v. Ross*, 601 F.2d 330, 334-35 (7th Cir. 1979), discussed later in this opinion; Seidman has not appealed from this dismissal. The RICO count was based on 18 U.S.C. § 1964(c), which gives a treble-damage remedy to "any person injured in his business or property by reason of a violation of" section 1962. Read in conjunction with section 1961, section 1962 forbids a person or firm that has income from certain types of criminal activity to use that income to acquire any interest in an enterprise affecting interstate commerce. Seidman alleges that Cenco's corporate acquisitions with stock whose price had been inflated through violations of various federal criminal securities statutes violated RICO. The district court dismissed Seidman's RICO claim, without reaching the merits, on the ground that Seidman lacked standing to maintain it.

The question whether Congress intended to grant a treble-damages remedy to people or firms injured in the way Seidman was injured, that is, as a consequence of being used as a tool of the criminal enterprise, is apparently one of first impression. The language of section 1964(c) provides no answer, analogies to section 4 of the Clayton Act are forced, and there is no useful legislative history relating to the provision. We therefore ask whether a treble-damages action by auditors of criminal enterprises would contribute to the compensatory and deterrent objectives of RICO. We think it would not, though not because the draftsmen of RICO were concerned with the penetration of lawful enterprises by "organized crime," a euphemism for what used to be called the Mafia, and there was nothing of that sort here. This court has interpreted the RICO statute, in light of the long list of criminal offenses in section 1962, to forbid penetration of business enterprises by any "pattern of racketeering activity" embraced by that section, whether or not "organized crime" is involved. *United States v. Aleman*, 609 F.2d 298, 303-04 (7th Cir. 1979). What is critical here, rather, is that "the primary purpose of RICO is to cope with the infiltration of legitimate businesses." *United States v. Turkette*, 101 S. Ct. 2524, 2533 (1981). It is presumably on behalf of the

owners, perhaps also the customers and competitors, of such businesses that the civil damages remedy was created, and not on behalf of the people who supply office equipment or financial or legal services to criminal enterprises that may be violating RICO. It is unlikely that Congress if it had adverted to the issue would have chosen to create in the wake of every RICO violation waves of treble-damage suits by all who may have suffered indirectly from the violation, especially when many of these would inevitably be, as here, the witting or unwitting tools of the violator. The RICO claim was correctly dismissed.

Seidman also asserted several common law claims (primarily fraud and breach of contract) which the judge dismissed for lack of proof of any injury. Because, as noted earlier, there is no concept of an inchoate tort, wrongdoing that has no impact is not tortious. The existence of impact or injury is therefore relevant to tort liability though the amount of injury is not. But the distinction is a fine one, and when a trial is separated into liability and damages phases the judge must be careful not to dismiss a complaint on liability grounds when the plaintiff was just reserving his damages evidence for the damages phase, as he had been told to do. Since the district judge in this case had, the day after trial began, tentatively approved the settlement under which Seidman agreed to pay $3.5 million to the class, Seidman naturally thought it had no need to present any evidence of injury at trial, and it did not. The district judge should have taken judicial notice of the settlement and held that Seidman's obligation thereunder was evidence enough of injury to withstand a directed verdict on liability. Apparently he did not do so because he thought Seidman was just seeking indemnification from a codefendant, which this court has held is not allowed in a Rule 10b-5 case. *Heizer Corp. v. Ross*, *supra*, 601 F.2d at 334-35. But indemnity is a remedy of one wrongdoer against another; and Seidman's claim is that it was a victim rather than a wrongdoer. It is true that it paid several millions to the class plaintiffs, but it never admitted wrongdoing or was adjudicated a wrongdoer. Therefore, if it can prove that Cenco defrauded it into

issuing false audit reports which in turn exposed it to liability to the class plaintiffs, the amount it paid to settle with the class would be a permissible item of damages. (Since Cenco's cross-claim was dismissed on liability grounds, we need not consider the possible implications of *Heizer* for Cenco's damage claim based on its settlement with the class plaintiffs—Cenco, unlike Seidman, being an admitted wrongdoer.)

Heizer shows, incidentally, that creating federal common law to decide the liabilities *inter se* of violators of the federal securities laws is not out of the question; *Heizer* was a federal common law case. Its rejection of indemnity as being contrary to the principle that one who is guilty of serious wrongdoing should not be let off scot-free has possible, and it would seem negative, implications for the merits of Cenco's claim against Seidman. But since the parties here do not seek to use *Heizer* beyond the indemnity issue, we leave for another day the question of the possible broader implications of that decision.

Since Cenco does not argue that the district judge's dismissal of Seidman's state-law counts can be supported on any alternative ground, we must vacate and remand this part of the judgment. But it does not follow that these counts must be retried. They may well be dismissed on remand for lack of federal subject-matter jurisdiction, though this is a question to be decided by the district court in the first instance.

The rule in pendent jurisdiction is that if the federal claim to which the state-law claim is pendent is dismissed before trial, the court will decline jurisdiction over the state-law claim and remit the claimant to the state courts. *United Mine Workers of America v. Gibbs*, 383 U.S. 715, 726 (1966). The RICO claim, the only federal claim to which Seidman's common law counts could be pendent, was not dismissed before trial, so the rule just stated is not strictly applicable. On the other hand, since Seidman is seeking a new trial on those counts, the dismissal of the RICO claim which we affirm today is a dismissal of the main count before trial of the common law counts, more precisely before retrial of them. The

position is the same if jurisdiction to decide Seidman's common law claim is based on the concept of ancillary rather than of pendent jurisdiction. Since the claims to which Seidman's claim are ancillary, namely the claims of the plaintiffs in the original class action, have all been finally disposed of, there will be no federal question remaining in the case when Seidman's common law counts are retried; and pendent and ancillary jurisdiction are treated the same so far as the rules governing retention of the nonfederal claim after dismissal or other final disposition of the federal claim are concerned. See *Federman, supra.*

But the *Gibbs* rule stated above obviously was meant for cases where the federal claim is dismissed early in the litigation, before there have been significant proceedings on either the federal or the pendent (or ancillary) state claim. Where, as in this case, both claims have been tried once, the considerations of judicial economy that underlie the doctrines of pendent and ancillary jurisdiction support retention of the state claim for retrial. But these considerations are not necessarily decisive. The exercise of pendent jurisdiction is not mandatory. See *Gibbs, supra,* 383 U.S. at 726-27. Since there must be a new trial from scratch in this case, since the litigation has now narrowed down to a dispute between two citizens of the same state over the application of state law to their dispute, since Seidman's claim against Cenco involves novel and difficult issues of state law, and finally since the judge who presided over the first trial has resigned from the bench, it may well be that the second trial should be in a state court. The district court will have to decide this on remand, balancing the considerations we have just listed against any judicial economies from retaining the matter in federal court, where it began.

The district court on remand will also have to reconsider the order awarding Seidman $76,000 in taxable costs. Seidman was entitled to costs only if it was the "prevailing party." Fed. R. Civ. P. 54(d). It was the prevailing party on Cenco's cross-claim, but not on its own. True, "a defendant who successfully fends off a large claim may be awarded costs despite failure to

prevail on a counterclaim." *Scientific Holding Co. v. Plessey Inc.*, 510 F.2d 15, 28 (2d Cir. 1974). The court below thought this precept applicable here because it regarded Seidman's claims against Cenco as in the nature of defenses to Cenco's claim. But we cannot accept that characterization. Just as Cenco sought by its cross-claim against Seidman to shift the cost of its settlement with the class to Seidman, so Seidman sought by its cross-claim against Cenco to shift the cost of its settlement with the class to Cenco. And while Cenco's settlement with the class was larger than Seidman's—$11 million versus $3.5 million—Seidman had other damage claims against Cenco (and vice versa). Finally, although the court dismissed Seidman's cross-claim before the case went to the jury, the trial had been as much concerned with Seidman's as with Cenco's claims—they are not separable.

If we were affirming the dismissal of Seidman's cross-claim in its entirety, therefore, we would conclude that neither party had prevailed. But since we are reversing the dismissal of the common law counts in Seidman's cross-claim, Seidman may yet prevail, so we shall vacate the order taxing costs to abide the event.

Both parties quarrel with the computation of costs by the trial judge, and the court below may want to re-examine that computation should an award of costs become appropriate. We decline to do so ourselves because the entire matter will be academic if the court below should decide not to exercise jurisdiction over Seidman's state-law claims and by dismissing them demonstrate that Seidman is no more the prevailing party in this litigation than Cenco.

Last, we reject Cenco's complaint that the trial court committed reversible error in allowing Seidman's expert witness to testify without—Cenco argues—an adequate foundation. This was a matter within the trial judge's discretion. We do not think he abused it but in any event it is not a sufficiently prejudicial error standing alone to warrant undoing a seven-week trial.

The judgment appealed from is affirmed except that the dismissal of the common law counts in Seidman's

cross-claim, and the order taxing costs, are vacated and remanded for further proceedings consistent with this opinion. The parties shall bear their own costs in this court.

SO ORDERED.

A true Copy:
Teste:

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APPENDIX B

United States District Court

Northern District of Illinois
Eastern Division

Name of Presiding Judge, Honorable JOHN POWERS CROWLEY

Cause No.: MDL 291 Date: June 10, 1981
75 C 2227 & all consolidated cases

Title of Cause: IN RE CENCO INCORPORATED SECURITIES LITIGATION,
Robert Helfand, et al v Cenco, Inc., etc.

Cenco, Inc.'s motion for judgment notwithstanding the verdict and a new trial is denied.

/s/ JOHN POWERS CROWLEY
United States District Judge

APPENDIX C

United States District Court

For the Northern District of Illinois
Eastern Division

CENCO, INC.	*Plaintiff,*	No. 75 C 2227 MDL 291
vs.		
SEIDMAN & SEIDMAN,	*Defendant.*	JUDGMENT

This action came on for trial before the Court and a jury, Honorable JOHN POWERS CROWLEY, United States District Judge, presiding, and the issues having been duly tried and the jury having duly rendered its verdict.

It is Ordered and Adjudged that as to fraudulent audit opinions, we the jury find the issues against the plaintiff Cenco and in favor of the defendant Seidman & Seidman. As to professional malpractice (negligence), we the jury find the issues against the plaintiff, Cenco and in favor of the defendant Seidman & Seidman. As to breach of contract, we the jury find the issues against the plaintiff, Cenco and in favor of the defendant Seidman & Seidman. (three verdicts) Enter judgment.

Dated at Chicago, Illinois, this 27th day of June, 1980.

/s/ H. STUART CUNNINGHAM
Clerk of Court

/s/BARBARA J. BROTHERSON
Deputy Clerk

APPENDIX D

THE COURT: All right, ladies and gentlemen, we now come to the next to the last stage of a trial, and that is my instructions to you. The last stage, of course, will be your deliberations on the verdict in this case.

Now, when I give you these instructions, I tell you it's your duty to follow these instructions. You are not to question any rule of law stated by me to you in these instructions, and regardless of any opinion you may have as to what the law ought to be, you must base your verdict upon the law as I give it to you.

And it's your duty to determine the facts from the evidence in this case, and then you are to apply the law given in these instructions to the facts, and in this way, you are going to decide the case.

Now, there are and have been separate actions related to this case involving parties other than Cenco and Seidman. You should not concern yourself with the rights of those other parties or the outcome of those separate cases. Your only concern should be with the evidence and the instructions with respect to the two parties to this case, Cenco, Incorporated, and Seidman and Seidman.

When I give you these instructions, and I'm also going to tell you that not only by the instructions, but any ruling I may have made in the course of the trial, or remark that I may have made in the course of the trial I don't mean to indicate any opinion as to the facts of this case, or what your verdict should be. You are the sole and exclusive judges of the facts.

There have been occasions during the case, for example, when I have sustained an objection, or when I have overruled an objection. I don't sustain or overrule objections with regard to whether I consider the evidence to be important or

unimportant. That's up to you. I sustain or overrule objections based upon what I perceive the law to be as to the propriety of the objection.

Don't try and figure out how I would decide this case if I were the finder of fact. I'll tell you this: I have an opinion as to what your verdict should be. Your verdict should be what you 12 people say it is, all right? I'll tell you what the law is. You are the experts on the facts.

Just to remind you again, the opening statements of the lawyers are for the purposes of acquainting you in advance with the facts they expect the evidence to show, and the closing arguments are for the purpose of discussing the evidence. They are not evidence themselves, and they should be disregarded to the extent that they are not supported by the evidence.

We were talking about objections before. During the course of the trial, it often becomes the duty of counsel to make objections, and for me to rule upon them in accordance with law. The fact that a lawyer may have made objections should not influence you in any way. They are just performing your function—their function. Now, what is the evidence? The evidence in this case consists of the sworn testimony of the witnesses, both live and by deposition, the exhibits received in evidence, and the stipulated or the admitted facts.

Now, we had some stipulations yesterday. We had a stipulation if certain people were called to testify, they would claim their privilege against self-incrimination under the Fifth Amendment. It was agreed by the parties. And the stipulation is an agreed statement of facts, and you should regard those agreed statements as true.

You are to consider only the evidence received in this case, and you should consider this evidence in the light of your own observations and experiences in life. And you may draw such reasonable inferences as you believe to be justified from the proven facts.

You are to disregard any evidence to which I have sustained an objection or which I ordered stricken, and anything you may have seen or heard about this case outside the courtroom is not evidence and must be entirely disregarded.

You should not be influenced in any way by sympathy, prejudice, fear, or public opinion.

Now, we talk about evidence. And Mr. Bartlit mentioned it in his closing argument yesterday.

There are generally two types of evidence, direct and circumstantial. And direct evidence is the testimony of a person who claims to have personal knowledge of the facts which have been charged, such as an eye witness. And circumstantial evidence is the proof of a chain of facts and circumstances which tends to show whether one party's claim against the other is true or untrue.

The law makes no distinction between the weight to be given either direct or circumstantial evidence. Therefore, all of the evidence in the case, including the circumstantial evidence, should be considered by you in arriving at your verdict.

And Mr. Bartlit told you I use an analogy to explain the difference between the two, and I like to think of the man and woman at home on an evening, it is a winter's evening in November, and we haven't yet had any snow. The husband goes upstairs and he goes to bed. There is no snow on the ground. The wife is still downstairs. She looks out of the window and she sees it is starting to snow, and it is the first snow of winter, and we all know how beautiful that first snow is, that first one. All right, she watches it snow and then she goes upstairs.

They come down in the morning and they look and the ground is covered with snow, and they both say, "It snowed last night."

The wife knows that it snows because of direct evidence, she saw it snow, she is an eyewitness.

The husband knows it snowed because of circumstantial evidence; it isn't snowing now, but when he went to bed last night there was no snow on the ground and when he got up in the morning there was snow on the ground. Circumstantially, it snowed last night.

That is the difference. Circumstantial evidence is not second-class evidence.

During the trial, certain evidence was presented to you by the reading of depositions, and this evidence is entitled to neither more nor less consideration than you would give the same testimony had the witnesses appeared in open court.

You are the sole judges of the credibility of the witnesses, and of the weight to be given to the testimony of each of them. In considering the testimony of any witness, you may take into account his intelligence, ability and opportunity to observe, age, memory, manner while testifying, any interests, bias or prejudice that witness may have, and the reasonableness of his testimony considered in the light of all of the evidence in the case.

Evidence that on some former occasion a witness made a statement inconsistent with his testimony in this case may be considered by you in determining the credibility of a witness.

I also want to tell you that it is proper for an attorney to interview any witness in preparation for trial. Indeed, every attorney, if he can, he or she can, will interview a witness so you know what they are going to say.

Now, we are going to be talking about burdens of proof in this case, and when I say that a party has the burden of proof on any proposition, or use the expression "if you find," or "if you decide," or "preponderance of the evidence," I mean you must be persuaded, considering all of the evidence in the case, that the proposition on which a party has the burden of proof is more probably true than not true.

Now, a corporation or a partnership cannot act for itself, they may only act through their agents, and agents of a corporation are the officers and employees. Agents of a partnership are the partners and employees, and corporations and partnerships are legally responsible for those acts or omissions of agents made or performed within the scope of their employment. To be acting within the scope of employment, the agent first must have intended that the act must produce some benefit to the corporation or partnership; second, the agent must have been acting within the scope of authority. An act was within the agent's authority if it was directly related to the performance of the type of duties that the employee had the general authority to perform, or if outsiders could reasonably assume that the agent had the authority to perform the act, judging from the position with the company, the circumstances surrounding past conduct.

A corporation and a partnership is deemed to have knowledge of a fact or event whenever one of its agents, such as its officers or one of its other employees whose duties involve receiving information of such a fact or event, has such knowledge.

Similarly, notice given to such an agent of a corporation with respect to any matter within the scope of the agent's responsibilities operates as a notice to the corporation or the partnership, as the case may be. The change of management or ownership does not relieve a corporation of responsibilities for wrongs committed by prior management.

We are going to be talking about knowingly in these instructions, or knowledge.

To act knowingly or with knowledge means that a party realized what it was doing and was aware of the nature of its conduct, and did not act through ignorance, mistake or accident.

Now, Cenco has three basic claims against Seidman. As to each one of those claims there are certain things that Cenco must prove by a preponderance of the evidence, and I am

going to try and break down these instructions into three groups, because there are different principles that apply to each of the claims.

First, Cenco claims that Seidman & Seidman breached its contracts with Cenco. To prove a breach of contract by Seidman, Cenco is required to show the following by a preponderance of the evidence, all four of these things which I am going to read to you:

1. That they had contracts with Seidman.

2. That Cenco performed all obligations it may have had to Seidman under the contracts.

3. That Seidman failed to perform its contractual obligations to Cenco.

4. That Cenco suffered injury as a proximate result of Seidman's breach and not a result of its own conduct or omissions.

A contract is an agreement between legally competent persons, in which one of the parties agrees to do or not to do a particular thing, and in which the other agrees to pay money or to give some other benefit in return, and a valid contract may be either written or oral.

In this case, Cenco alleged that it had contracts with Seidman for the years 1970 through 1974 in which Seidman agreed to perform audits of Cenco's financial statements, to express an opinion on Cenco's financial statements and to do certain other things. Seidman does not dispute that it had these contracts with Cenco.

Therefore, I instruct you that Cenco did have written and oral contracts with Seidman for the years 1970 through 1974, and that Cenco had rights under those contracts.

Cenco also alleges that it paid Seidman all the fees and expenses which it agreed to pay for Seidman's services, and Seidman also admits that it was paid by Cenco.

Now, we were talking about the fourth element of the claim, that Cenco had to prove an injury. In determining whether Cenco has proven the fourth element of its contract claim, you may separately consider the different types of injuries claimed by Cenco. To prove the fourth element of its contract claim, Cenco is not required to prove every type of injury it claims, it is sufficient that it prove any type of injury.

Seidman contends that Cenco's claims relating to the 1970 audit and opinion on Cenco's financial statements are barred by the statute of limitations.

The statute of limitations is a general statute that says that you have to bring an action within so many years, all right?

It is agreed that the 1970 audit and opinion were before the time for which recovery of damages would normally be permitted in this case under the applicable statute of limitations.

Cenco contends that the fraudulent concealment by Seidman suspends the statute of limitations and permits Cenco to recover on its claims for the year 1970.

Cenco must prove by a preponderance of the evidence fraudulent concealment by Seidman before you can consider Seidman's liability on the claims relating to the year 1970. Cenco may establish fraudulent concealment by Seidman in either of two ways—again, they have to do this by the preponderance of the evidence:

First, they may establish concealment by proving, one, that Seidman took affirmative acts or made affirmative representations designed to prevent Cenco from discovering its claims for the year 1970 and, two, that Seidman's acts or representations prevented Cenco from discovering its claims before March of 1972.

Cenco may establish fraudulent concealment by proving that Seidman had a relationship of trust or confidence to

Cenco, and that Seidman failed before March of 1972, to disclose to Cenco the facts giving rise to Cenco's claims for the year 1970.

The law provides that a party to a contract is entitled to perform its obligations under the contract without interference or obstruction by the other parties to the contract.

Accordingly, if you find that Seidman did not conduct its audits in accordance with Generally Accepted Auditing Standards, you may consider whether Cenco prevented Seidman's performance of its audits in accordance with Generally Accepted Auditing Standards, in determining Seidman's liability on this claim.

You have heard many references during the trial to General Accepted Auditing Standards. They are written standards of conduct for the accounting profession. Generally Accepted Auditing Standards are the standards which Seidman agreed to follow in its contracts with Cenco, and Seidman was required by its contract to follow the Generally Accepted Auditing Standards.

One of the auditing standards is called the Second Standard of Field Work. It requires that the outside CPA must review the company's internal auditing control procedures. As you have heard during the trial, internal controls are the methods used by a company to protect its financial records from bookkeeping errors or fraud. The sole responsibility for establishing these internal controls is the company's not the auditor's. An outside auditor like Seidman must review the internal controls in order to learn how far the auditor can trust those controls to prevent accounting errors and fraud and, consequently, how far he can trust the company's financial records themselves.

The Statements on Generally Accepted Auditing Standards require that an auditor make a proper study and evaluation of internal controls. The statements require that an auditor must do more audit work if he finds weak internal controls than he would if he found good internal controls.

An audit has the purpose of preventing or detecting material errors and irregularities in the financial statements. In making his audit, the outside auditor must consider the types of errors and irregularities that could occur.

Another auditing standard is called the Third Standard of Field Work. It requires that the auditor must obtain sufficient competent audit evidence, through inspections, observations, inquiries and confirmations to afford a reasonable basis for giving an opinion on the financial statements.

The Statements on Generally Accepted Auditing Standards require the outside auditor to obtain competent audit evidence with respect to material assets on inventories of the company. When a company figures its inventory quantities solely by means of a year-end count of the physical inventory, it is ordinarily necessary for the outside auditor to be present at the time of the inventory count. It may not be necessary, depending on the circumstances, that the auditor be present at each inventory location, so long as the auditor does enough observation, tests, and inquiries to determine the reliability of the company's representations about the quantity of its inventories pursuant to Generally Accepted Auditing Standards.

Another auditing standard is called the Third General Standard of auditing. It requires that the auditor exercise due professional care in the performance of his audit and the preparation of his opinion.

The due care requirement imposes a responsibility on each person within the independent auditor's organization to observe the standards of GAAS, or the generally accepted auditing standards. It also requires critical review at every level of supervision of the work done and the judgment exercised by those assisting in the audit examination.

The due care standard requires, in addition, that the content of the auditor's work papers be sufficient to provide an important support for the auditor's opinion, including his representation as to compliance with auditing standards.

Work papers are the records kept by the independent auditor of the procedures he followed, the tests he performed, the information he obtained, and the conclusions that he reached pursuant to the examination. Work papers, accordingly, may include work programs analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor.

Another section provides guidance for the independent auditor regarding work papers for examinations of financial statements or for other engagements to which any of the GAAS apply. There is no intention to specify the form or details of contents of work papers since they are designed to meet the circumstances and the auditor's needs on the individual engagement. In other words, there is no absolute form. Nor is there any intention to imply that the auditor would be precluded from supporting his opinion and his representation as to compliance with the auditing standards by other means in addition to work papers.

The statements on generally accepted auditing standards describe situations involving fraud within the company. It states that the ordinary audit cannot be relied upon to assure that fraud or deliberate misrepresentations by management will be discovered. It also states that the auditor is not an insurer or guarantor if it turns cut that fraud occurred and the auditor failed to discover it. But the auditor's obligation for not finding fraud depends on whether he conducted the audit with due professional skill and care in accordance with generally accepted auditing standards. The auditor may have responsibility for failing to detect fraud when such failure clearly results from his failure to comply with generally accepted auditing standards.

The standards require that the outside auditor must be aware at all times of the possibility that fraud may exist in the company. The auditor must also recognize when doing his work that the financial statements may be misstated as

the result of defalcations and similar irregularities, or deliberate misrepresentations by management, or both.

And the auditing standards require that the auditor must recognize and give consideration to these possibilities of fraud even in the ordinary audit examination.

When an independent auditor's examination leading to an opinion on financial statements discloses specific circumstances that make him suspect that fraud may exist, he should decide whether the fraud, if in fact it should exist, might be of such magnitude as to affect his opinion on the financial statements. If the independent opinion—I am sorry—If the independent auditor believes that fraud so material as to affect his opinion may have occurred, he should reach an understanding with the proper representatives of the client as to whether the auditor or the client, subject to the auditor's review, is to make the investigation necessary to determine whether fraud has in fact occurred, and, if so, the amount thereof. If, on the other hand, the independent auditor concludes that any such fraud could not be so material as to affect his opinion, he should refer the matter to the proper representatives of the client with the recommendation that it be pursued to a conclusion.

In making the ordinary examination, the independent auditor is aware that the possibility of the fraud may exist. Financial statements may be misstated as the result of defalcations and similar irregularities, or deliberate misrepresentation by management, or both. The auditor recognizes the fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result. Similarly, although the discovery of deliberate misrepresentation by management is usually more closely

associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud arises only when such failure clearly results from failure to comply with generally accepted auditing standards.

The independent auditor should be thorough in his search for evidential matter and objective in his valuation. In selecting procedures to obtain competent evidential matter, he should recognize the possibility that the financial statements may not be presented fairly in conformity with generally accepted accounting principles. In developing his opinion, the auditor must give consideration to relevant evidential matter regardless of whether it appears to support or to contradict the representations made in the financial statements.

The independent auditor's objective is to obtain sufficient competent evidence to provide him with a reasonable basis for forming an opinion under the circumstances. In the great majority of cases, the auditor finds it necessary to rely on evidence that is persuasive rather than convincing. Both the individual assertions in financial statements and the overall proposition that the financial statements as a whole present fairly in accordance with Generally Accepted Accounting Principles, the financial position, results of operations, and changes in financial position are of such a nature that even an experienced auditor is seldom convinced beyond all doubt with respect to all aspects of the statements being examined.

To the extent that the auditor remains in substantial doubt as to any assertion of material significance he must refrain from formulating an opinion until he has obtained sufficient competent evidence to remove such substantial doubt, or he must express a qualified opinion or a disclaimer or opinion.

Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. An independent auditor may make suggestions as to the form or content of financial statements, or he may draft them in whole or in part, based on managements accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of management.

Now, the instructions that I have just given you concerning Cenco's contract claims also apply to Cenco's second claim, which is a claim of professional malpractice or, in other words, negligence. Seidman assumed a professional as well as a contractual duty to Cenco when Seidman entered into its audit agreements with Cenco.

In order to recover on a claim of professional malpractice, Cenco must prove by a preponderance of the evidence:

1. That Seidman failed to comply with Generally Accepted Auditing Standards in performing its audits;

2. That Cenco suffered injury as a result of such negligence; and,

3. That Cenco was not guilty of contributory negligence or fraud.

Contributory negligence is fault involving negligence on the part of an injured party which combines or co-exists to

some degree with the negligence of another, and thus helps to bring about the suffered injury.

When Seidman agreed to serve as Cenco's auditor, it undertook a duty to perform without negligence and to meet the standards of care reasonably expected of persons holding themselves out as skilled accountants.

The standard of care imposed on Seidman included the duty to satisfy Generally Accepted Auditing Standards.

You have heard evidence that employees of Cenco tried to conceal the inventory fraud from Seidman by lies, falsifications and tricks. I instruct you that the question you should consider is not whether such concealment was attempted, but whether it was successful. If you find, as Seidman contends, that it never discovered the fraud, you may consider any concealment attempts in determining whether Seidman acted with reasonable care and prudence in its audits.

Also, if you find that Seidman failed to do its job in accordance with Generally Accepted Auditing Standards, Seidman is responsible for its own decisions. However, you may consider whether negligent or fraudulent acts of officers, directors and employees of Cenco prevented Seidman from following generally accepted auditing standards.

Cenco claims that the audit opinions that were given by Seidman to Cenco were fraudulent. We will call this the fraudulent audit opinions count. And Cenco claims that they were unqualified—the unqualified audit reports and opinions for the years 1970 through 1974 were fraudulent.

A claim of fraud requires that Cenco prove each of the following elements, and again by a preponderance of the evidence:

1. That Seidman made a statement of a material fact;

2. That Seidman's statement was untrue;

3. That Seidman knew or believed its statement to be untrue;

4. That Cenco had a right to rely on Seidman's statement and did rely;

5. That Seidman made the statement for the purpose of inducing Cenco to act; and

6. That Cenco's reliance on the statement has led to injury.

So you see in each one of these claims there are different things that have to be proved. And they are in the instructions, and you will have them back in the jury room in helping you in your deliberations.

On the contract claim, there's four things; on the negligence claim, there's three things; on the fraudulent audit opinion, there are six things. And they all have to be proven by a preponderance of the evidence.

I can tell you that Seidman owed a legal duty to Cenco to give its audit opinions without fraud.

You should consider two ways in which an auditor's opinion can be fraudulent. First, fraud can be shown by representation in the audited opinion which the auditor knows to be false; or, second, fraud can be shown by representations in the audited opinion in which the auditor pretends to have material knowledge which he does not have.

You must decide whether Seidman had a fraudulent state of mind when it issued the audit opinions to Cenco.

Fraud includes not only the knowledge that a statement is false, but also a reckless disregard of whether the statement is true or false.

An auditor may not shut his eyes in reckless disregard of his knowledge that highly suspicious accounting figures, known to him to be suspicious, are being inserted in the client's records and report.

A party cannot claim to have relied on a statement which it knew to be false. Therefore, if you find that Cenco knew of the falsity of any false representation made by Seidman to Cenco, then you must find that Cenco did not rely on Seidman's representation.

And a participant in a fraud cannot recover damages suffered as a result of the fraud from another participant in the fraud. Therefore, if you find that Cenco, through the conduct or acts of its officers or employees, was a participant in the fraud, you must find Seidman not liable to Cenco on its claims of fraudulent audit opinions in Cenco's third claim.

In your deliberations you are only to consider whether or not Seidman is liable on any of Cenco's claims. You are not to consider or speculate on the amount of any damage. If Seidman is found to be liable the question of the amount of damage will be considered in another—will be considered in another trial. If Seidman is found not liable, there will be no reason to consider damages.

Now, you are about to go off and begin your deliberations to reach a verdict. One of the first things that you are going to do is elect a foreman. And the foreman will be—I'm not going to tell you how to elect—I don't know if you have to have primaries or anything else—but you will just select one of your members who will preside over your deliberations and make them orderly. That's all. It's just to organize them. The foreman doesn't have any greater vote than anyone else. But the foreman will be, if necessary, your spokesperson here in court, your representative.

In reaching your verdict, your verdict must represent the considered judgment of each of you. Your verdict, whether it be guilty or not guilty, must be unanimous. You should make every reasonable effort to reach a verdict. And in doing so you should consult with one another, express your own views, and listen to the opinion of your fellow jurors. Discuss your differences with an open mind. Don't hesitate to reexamine your own views and change your opinion if you

come to believe that it is wrong. But you should not surrender your honest beliefs about the weight or effect of evidence solely because of the opinion of your fellow jurors or for the purpose of returning a verdict.

The 12 of you should have fair and equal consideration to all of the evidence and deliberate with the goal of reaching an agreement which is consistent with the individual judgment of each juror. Although you are 12, you are 12 individuals.

Now, we are talking about verdict forms. You are going to have nine verdict forms in this case, three on each count. And I'll just take one. The one that I have picked up happens to be in relation to the last claim, which we have entitled "Fraudulent audit opinions."

If you find that Cenco has proven all of the essential elements that they have to prove under this count by a preponderance of the evidence against Seidman and you return a verdict against Cenco for all of the years involved, 1970 through 1974—you should give separate consideration to each year—you will sign this form of verdict:

"We, the jury, find the issues in favor of the plaintiff Cenco, and against the defendant, Seidman & Seidman."

It will be signed by your foreman and 11 other jurors.

If, on the other hand, you find on this claim in favor of Seidman and against Cenco on all of the years involved, you will sign this form of verdict:

"We, the jury, find the issues against the plaintiff, Cenco, and in favor of the defendant, Seidman & Seidman."

Now, Mr. Bartlit was talking to you yesterday about the form of verdict and checking off some things. I have got to tell you that's how I told them originally we were going to do it, and then I changed that without telling them. But it's substantially the same thing as what he was saying.

If you find on this claim that Cenco has proven its claims for some years and not others, for 1970 through 1974, you will sign this form of verdict:

"We, the jury, find the issues in favor of the plaintiff, Cenco, for the years"—and there's a blank, and you write in the years—"and in favor of the defendant, Seidman & Seidman, for the years" and you will write in those years.

So you will have three forms as to the audit opinions, three forms as to the breach of contract, and three forms as to the professional malpractice or negligence count.

I don't anticipate that you will need to communicate with me during your deliberations. If you do, however, the only proper way is in writing, signed by the foreperson, or if she—if he or she is unwilling to do so, by some other juror, and then you give it to the Marshal, all right?

All right, ladies and gentlemen, you may retire to begin your deliberations on the verdict. The lawyers will be assembling the exhibits, which will be sent back to you during your deliberations. I will be making an extra copy of these instructions so that you will have the instructions with you in the deliberations. You might say, on that point, why, if the Judge is going to send us the instructions, why did he read them to us?

There's two good reasons: First of all, the law requires me to read them to you; but, secondly, we all know some of us learn better by hearing, some of us learn better by seeing, so you will have it both ways.

So you may go back, ladies and gentlemen, and begin your deliberations.

The Marshal will be making arrangements today for your lunch, so you just let him know when you want to eat, and he will take care of you—our gimpy Marshal.

All right, ladies and gentlemen, you may retire.

APPENDIX E

Opinion by Judge Posner

JUDGMENT—ORAL ARGUMENT

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

March 26, 1982

Before: Hon. William J. Bauer, Circuit Judge
Hon. Harlington Wood, Jr., Circuit Judge
Hon. Richard A. Posner, Circuit Judge

CENCO INCORPORATED,
Cross-Claimant-Appellant,
Cross-Defendant-Appellee,

Nos. 81-2126
81-2264

vs.

SEIDMAN & SEIDMAN,
Cross-Defendant-Appellee,
Cross-Claimant-Appellant.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 75-C-2227

Judge John Powers Crowley and Judge Marvin E. Aspen

This cause was heard on the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, AFFIRMED except that the dismissal of the common law counts in Seidman's cross-claim, and the order

taxing costs, are vacated and remanded for further proceedings consistent with this opinion; with each party to bear its own costs on appeal; in accordance with the opinion of this Court filed this date.

APPENDIX F

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

April 30, 1982

Before: Hon. William J. Bauer, Circuit Judge
Hon. Harlington Wood, Jr., Circuit Judge
Hon. Richard A. Posner, Circuit Judge

CENCO INCORPORATED,
Cross-Claimant-Appellant,
Cross-Defendant-Appellee,
NOS. 81-2126
81-2264

vs.

SEIDMAN & SEIDMAN,
Cross-Defendant-Appellee,
Cross-Defendant-Appellant.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 75-C-2227

John Powers Crowley
and
Marvin E. Aspen
Judges

ORDER

On April 9, 1982, Cenco Incorporated filed a petition for rehearing with suggestion for rehearing en banc. All of the judges of the original panel have voted to deny the petition, and none of the active members of the court has requested a vote on the petition. The petition is therefore DENIED.

APPENDIX G
STATUTES AND REGULATIONS INVOLVED

Section 12 of the Securities Exchange Act of 1934, 15 U.S.C.

§ 78*l*. Registration requirements for securities.

* * *

Procedure for registration; information

(b) A security may be registered on a national securities exchange by the issuer filing an application with the exchange (and filing with the Commission such duplicate originals thereof as the Commission may require), which application shall contain—

(1) Such information, in such detail, as to the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer, and any guarantor of the security as to principal or interest or both, as the Commission may by rules and regulations require, as necessary or appropriate in the public interest or for the protection of investors, in respect of the following:

* * *

(J) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;

(K) profit and loss statements for not more than the three preceding fiscal years certified if required by the rules and regulations of the Commission by independent public accountants.

Section 13 of the Securities Exchange Act of 1934, 15 U.S.C.

§ 78m. Periodical and other reports.

Reports by issuer of security, contents

(a) Every issuer of a security registered pursuant to section 78*l* of this title shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security—

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 78*l* of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange.

Form of report; books, records, and internal accounting; directives

(b) (1) The Commission may prescribe, in regard to reports made pursuant to this chapter, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation

of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter (except that such rules and regulations of the Commission may be inconsistent with such requirements to the extent that the Commission determines that the public interest or the protection of investors so requires).

RULES OF THE SECURITIES AND EXCHANGE COMMISSION FROM VOL. 17, CODE OF FEDERAL REGULATIONS

§ 210.2-02 Accountants' reports.

• • •

(b) *Representations as to the audit.* The accountant's report: (1) Shall state whether the audit was made in accordance with generally accepted auditing standards; and (2) shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission. Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this section.

(c) *Opinion to be expressed.* The accountant's report shall state clearly: (1) The opinion of the accountant in respect of the financial statements covered by the report and the

accounting principles and practices reflected therein; and (2) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(d) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given. (See Release No. AS-4.)

§ 210.3-01 Consolidated balance sheets.

(a) There shall be filed, for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years.

§ 210.3-02 Consolidated statements of income and changes in financial position.

(a) There shall be filed, for the registrant and its subsidiaries consolidated, audited statements of income and changes in financial position for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed.

§ 210.4-01 Form, order, and terminology.

(a) Financial statements should be filed in such form and order, and should use such generally accepted terminology, as will best indicate their significance and character in the light of the provisions applicable thereto. The information required with respect to any statement shall be furnished as a minimum requirement to which shall be added such further material information as is necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.

(1) Financial statements filed with the Commission which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the Commission has otherwise provided. This article and other articles of Regulation S-X provide

clarification of certain disclosures which must be included in any event, in financial statements filed with the Commission.

• • •

§ 240.14a-3 Information to be furnished to security holders.

• • •

(b) If the solicitation is made on behalf of the issuer, and relates to an annual meeting of security holders at which directors are to be elected, each proxy statement furnished pursuant to paragraph (a) of this section shall be accompanied or preceded by an annual report to security holders as follows:

(1) The report shall include, for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years and audited statements of income and changes in financial position for each of the three most recent fiscal years prepared in accordance with Regulation S-X (Part 210 of this chapter), except that the provisions of Article 3, other than § 210.3-06(e), shall not apply and only substantial compliance with Articles 6, 7, 7A and 9 is required. Any financial statement schedules or exhibits or separate financial statements which may otherwise be required in filings with the Commission may be omitted. Investment companies registered under the Investment Company Act of 1940 need include financial statements only for the last fiscal year. If the financial statements of the registrant and its subsidiaries consolidated in the annual report filed or to be filed with the Commission are not required to be audited, the financial statements required by this paragraph may be unaudited.

APPENDIX H

IN THE

United States District Court

Northern District of Illinois
Eastern Division

ROBERT HELFAND, et al.,
Plaintiffs,

vs.

CENCO, INC., et al.,
Defendants.

No. 75 C 2227

TRANSCRIPT OF PROCEEDINGS

had in the above-entitled cause before the Honorable JOHN POWERS CROWLEY, one of the Judges of said Court, in his courtroom in the United States Courthouse, Chicago, Illinois, on May 1, 1978, at 10:30 a.m.

• • •

[THE COURT:] The defendant Swiger's final argument is addressed solely to plaintiff's fifth cause of action, which sets out a derivative action on the part of Cenco shareholders.

Paragraph 41 of the fifth cause of action alleges that:

> "Because of the control of Cenco by the defendants, any demand for action requested by the Board of Directors of Cenco would be futile."

The Court agrees with the defendant that this vague allegation does not comport with the pleading requirements for derivative actions found in Rule 23.1, and, as has been

interpreted in this Circuit. In *Abrams* v. *Mayflower Investors, Inc.*, the Court held:

> "Merely because a putative majority of the directors are alleged to be implicated in the fraud on the corporation, the necessity for a demand upon the entire board continues and the general averments of complecity on the part of the directors in the wrong against which relief is sought will not bring the plaintiff within the exception to the rule."

Therefore, the defendant Swiger's motion to dismiss for failure to comply with Rule 23.1 is granted, and the fifth cause of action is accordingly dismissed without prejudice.

• • •

(Tr. Pr. 22-23)

CERTIFICATE OF SERVICE

David E. Springer, a member of the Bar of this Court and one of the counsel of record for petitioner, Cenco Incorporated, certifies that five (5) copies of the foregoing "Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit" were served by hand upon counsel of record for Seidman & Seidman, Samuel Weisbard, Esq., McDermott, Will & Emery, 111 West Monroe Street, Chicago, Illinois 60603, this 29th day of July, 1982. All parties required to be served have thus been served.

David E. Springer